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ETHICAL INVESTING: SMART BETA GOES GREEN

As investors move to view ESG as a driver of better returns, **Alix Robertson** looks at how the approach can be incorporated into smart beta investing.

Environmental, social and governance (ESG) issues in investing are at a turning point, as the potential for the 'moral obligation' caterpillar to morph into an 'improved returns' butterfly is at last being considered seriously.

At Paris-based asset manager Tobam, president Yves Choueifaty is clear that sustainability should not be separated from financial performance. "It's not something that we do because we want to do good… It is in the very direct economic and financial interest of our clients to have sustainable performance," he says.

Choueifaty adds that in the smart beta domain, avoiding stocks that do not drive businesses in a sustainable way will not necessarily change the behaviour of a fund, because the focus is already on being well diversified.

Tobam focuses on maximum diversification, and the firm's attention to sustainability began with its second client asking about ESG inclusion. It quickly realised an ESG approach was very much in line with its broader methodology, says Choueifaty: "How can you claim you are a long-term investor if you don't look at sustainability?"

Monitoring the impact of the firm's ESG overlay on risk and performance has shown little negative effect. "We have been able to dramatically improve the sustainability profile of our portfolio when in fact this has impacted neither the performance enhancement of our strategy nor the risk reduction."

RobecoSAM, a Zurich-based investment firm that specialises in sustainability investing, has had similar discussions recently.

Dr Guido Giese, its head of indices, says that in the past few years investors have been moving away from ESG as an ethical hygiene factor and asking if it can be used in smart beta to improve performance. In response, the firm has gone a step further than using an ESG overlay, establishing a way to use ESG ratings to function like smart beta factors.

The firm is now creating ESG indices with S&P Dow Jones Indices and Giese says that RobecoSAM will be rolling out ESG versions of some of the very well-known benchmarks, such as the S&P 500, in the second half of this year.

At Axa Investment Managers, smart beta and ESG are also being combined in the fixed income space.

Lionel Pernias is the fund manager of the Axa Sterling SmartBeta Credit Bond Fund. He says: "The development of ESG is important to mitigate against event risk, so even if you have a very diversified portfolio, adding an ESG integration helps to mitigate these risks."

The firm's parent group, Axa, has a broad focus on ESG, and is aiming to triple its green investment footprint to reach to over €3 billion by 2020.

"This a theme that has started to shape the economy and the political and investment landscape, and it shows that ESG integration for bond investors is valuable. "ESG criteria can create quality… It helps you to improve returns over the long term and smart beta ESG is better diversified that an ordinary fixed income ESG portfolio," adds Pernias.

At RobecoSAM, Giese says he expects to see this growth in the combination of smart beta and ESG continue. "Doing ESG research is a lot of hard work, but if you can find alpha in data, people will do it because they want returns."

Link: http://www.funds-europe.com/smart-beta-report-2015/16440-ethical-investing-smart-beta-goes-green